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RUEHDO/AMEMBASSY DOHA 1545
RUEHNE/AMEMBASSY NEW DELHI 3364
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TAGS: EFIN ETRD ECON PREL PK
SUBJECT: STATE BANK CONCLUDES PAKISTAN'S ECONOMY SHOWING INCREASING SIGNS OF STRESS

¶1. (SBU) Summary: In its third quarter fiscal year 2008 report, the State Bank of Pakistan (SBP) highlighted the multiple pressures on the national economy from rising fiscal and current account deficits and inflation. As a result, the SBP has used USD 4.8 billion in reserves, putting downward pressure on the exchange rate. Pakistan currently has enough reserves to cover 18.1 weeks of imports, down from a previous import cover cushion of 30 weeks. Additionally, weak economic growth has reduced the likelihood that the Government of Pakistan (GOP) will reach its annual tax target of USD 15.3 billion (Rs.1.025 trillion). The decrease in estimated revenue collection, combined with higher fuel and food subsides, has pushed government borrowing from the SBP to over USD 8.2 billion (Rs.550 billion) or 5.5 percent of GDP. This borrowing is exerting further pressure on inflation, which will likely be compounded with price increases for fuel, wheat and other basic commodities. The SBP believes, however, that structural reforms and financial liberalization over the last fifteen years have created a substantially stronger and more resilient economy. End summary.

Economy Showing Signs of Stress
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¶2. (U) The State Bank of Pakistan (SMP) released its third quarter fiscal year 2008 performance report on May 31. (Note: Pakistan's fiscal year runs July 1 - June 30. End Note.) According to the report, Pakistan's economy is showing increasing signs of stress. A combination of adverse domestic and international developments has led to a deterioration in most macroeconomic indicators. Real GDP growth in FY08 is expected to drop below six percent for the first time in five years. Annual inflation is poised to return to double digits. Both fiscal and current account deficits as a percentage of GDP are forecast to rise substantially, with the current account reaching an all-time high. The weakness in the external account is also reflected in the drop in foreign exchange reserves and the depreciation of the rupee against the dollar.

¶3. (U) Despite the deterioration in key macroeconomic indicators, the SBP believes that Pakistan's economy is still fundamentally sound because of structural reforms and liberalization measures taken over the last fifteen years. As a result, a renewed GOP focus on further reforms and corrective measures could quickly reinvigorate economic growth.

Production Down Across the Board
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¶4. (SBU) According to the SPB, below target performance of major crops will contribute significantly to a slowdown in agricultural growth during the year. While the agriculture sector, on the whole, may post a positive growth rate due to the anticipated strong performance of livestock and minor crops such as lentils, below target performance by major crops (wheat, rice, barley, sugar cane and cotton) will push aggregate agricultural growth below the target of four percent.

¶5. (SBU) High international commodity prices, inadequate energy supplies and lingering political uncertainty all contributed to slower growth in large scale manufacturing (LSM) in FY08. The sector grew by 4.8 percent in the first nine months of the current fiscal year versus 9 percent in the same period last year. The largest contribution to LSM growth came from a sharp rise in sugar production. Excluding this sub-sector, the LSM growth rate dropped to 3.3 percent in the July 2007 to March 2008 period. The SBP expects that the manufacturing sector will improve in the coming months as multiple industries, including paper, tires, petroleum refining, fertilizer and cement plan to expand capacity. With the exception of cement, most of these expansion plans are aimed at reducing import dependency. Pakistani cement exports to the Middle East, India and Afghanistan have risen sharply over the last year.

¶6. (SBU) Expansionary fiscal policy has overshadowed and weakened the impact of the Bank's efforts to maintain a tight monetary policy. As of May 10, the GOP had borrowed a record USD 8.2 billion (Rs. 551 billion) from the SBP, compared to only USD 683 million (Rs. 45.7 billion) in the same period last year. The total outstanding stock of borrowings from the SBP has doubled over the last year and currently stands at USD 14 billion (Rs. 940.6 billion). The newly elected government has pledged to broaden the nation's tax base and decrease expenditures, publicly indicating an intention to diversify deficit financing mechanisms and reduce dependence on the State Bank.

Inflation and Deficits
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¶7. (U) The rise in international commodity prices pushed domestic inflation to its highest level in five years. The inflation growth rate for the first nine months of the current fiscal year is currently at 9.8 percent, up from 7.8 percent in 2007 and 8.2 percent in 2006. Pakistan's Consumer Price Index (CPI) increased 17.2 percent from the same time last year, driven by both food and non-food sub-groups. Food prices in April 2008 were 25.5 percent higher than in April 2007; food price inflation in May 2008 will top 26 percent.

¶8. (U) Pakistan's merchandise trade deficit widened to a record high of USD 16.8 billion for the first nine months of the current fiscal year, 37.8 percent higher than the fiscal year target. The deficit was fueled by both a surge in imports and below-target export growth. Increased food and petroleum imports contributed to more than half of the overall rise in prices. While the 10.2 percent annual export growth rate during the July 2007 to April 2008 period was an improvement over the previous fiscal year, it is significantly lower than the 12.4 percent growth target. Export growth was led by non-textile sectors; textile exports decreased by 2.5 percent during the period.

¶9. (U) The current account deficit expanded by 74.8 percent during the first nine months of the fiscal year, as compared to the same period last year. Continuing liquidity problems in international financial markets have led to a decrease in foreign inflows, making financing the deficit more challenging. However, strong growth in remittances as well as bilateral and multilateral budgetary support provided some relief.

FDI Declines While Reinvested Earnings Rise
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¶10. (U) Foreign Direct Investment (FDI) declined by 16.7 percent during the first nine months of the current fiscal year, following three years of more than 100 percent growth. Investment in telecommunications, power, petroleum and financial services declined

while investment in cement and oil and gas exploration increased. Most of the decline in FDI is a result of a shortage of new investments and increased country risk. Reinvested earnings grew by twelve percent, from USD 751 million to USD 837 million. The SBP commented that higher reinvested earnings reflect long term investor confidence in Pakistan and the profit potential of key sectors such as financial services, oil and gas exploration and cement.

Reserves Depletion Decreases Reserve Adequacy Ratios
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¶11. (U) Reserves declined sharply beginning in October 2007, mirroring a sharp rise in the current account deficit. As of May 23, the State Bank held $9.06 billion in reserves with commercial banks holding an estimated additional $2.3 billion. Reserves have decreased by close to USD 5 billion from an October 2007 high of USD 16.4 billion. The depletion of foreign exchange reserves has also eroded the reserve adequacy terms of weeks of imports. Pakistan currently has enough reserves to cover 18.1 weeks of imports, down from a June 2007 import cover cushion of 30.6 weeks. The SBP depleted its own reserves; commercial bank reserves remained stable at approximately USD 2.3 billion throughout the fiscal year.

The Rupee Regains Some Ground
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¶12. (U) After remaining stable for more than four years, the Pakistani rupee lost significant ground against the U.S. dollar, depreciating by 13.4 percent from July 2007 to May 21, 2008. The steep decline in the rupee's value as well as high foreign exchange market volatility prompted the SBP to intervene on May 23, increasing the discount rate by 150 basis points to 12 percent and imposing a 35 percent margin requirement for import letters of credit.

¶13. (SBU) Comment: The State Bank of Pakistan is understandably focused on last quarter's growing current account and fiscal deficits. We agree with the SBP that the only solution to Pakistan's growing account deficit is to increase exports and attract foreign investment and other inflows. Since over 50 percent of imports are food and fuel, and another 43 percent are industrial and agricultural inputs, clamping down on imports is not an option. While efforts to augment electricity generation capacity will increase machinery imports, increased FDI will depend on a reliable supply of energy.

¶14. (SBU) Comment continued: As the report points out, Pakistan's inflation worries are far from over as international commodity prices continue to rise. With the budget for fiscal year 2008-09 due on June 10, we will monitor whether the new government is able to make difficult but necessary decisions, including the phasing out of fuel subsidies and the removal of price supports to bring domestic wheat prices more in line with the international market. End comment.

PATTERSON